Proposal # 14: Increase or improve the R&D Tax Credit

Background information:
The Cabinet for Economic Development recently retained a third party consultant to develop a state-wide economic development strategic plan. One of the recommendations included in the strategic plan, titled Kentucky's Unbridled Future, was to expand on the Kentucky R&D Tax Credit. Sustainable growth is dependent on the ability to create an effective policy framework that can facilitate continuous innovation, among other factors. Innovation is arguably the result of research and development (R&D) activities. To spur R&D activity the state needs to incent firms and entrepreneurs to undertake long-term projects with greater confidence and reduced risks.

Kentucky currently has an R&D tax credit, but it is not consistent with what other states and professionals in the industry refer to as an R&D tax credit. The current tax credit is not part of an economic development program. It is a credit that is claimed directly on the tax return for

"…constructing, remodeling, and equipping facilities in this state or expanding existing facilities in this state for qualified research and includes only tangible, depreciable property, and does not include any amounts paid or incurred for replacement property;".

The taxpayer may claim up to 5% of the total cost and the carry-forward is 10 years.

Currently many states offer an R&D tax credit similar to the federal tax credit for R&D. The federal tax credit is a dollar-for-dollar credit against federal tax. R&D tax credits are available to any company that increases its qualified research spending. Brand new companies, existing companies embarking on R&D for the first time or established companies expanding their R&D budget are all eligible.

The federal credit as well as state credits modeled after the federal credit, allow recovery of operating expenses and research activity expenses, including in some cases salaries, payments to engineers or consultants, payments for IP development and other activities. Most start-up companies do not have the funding to build a facility or renovate a facility so a credit for construction and remodeling is no help. Many are renting space or working out of incubators. Also, larger existing companies conducting R&D are doing so in their existing facilities on an on-going basis without any new capital expenditures for the space they use. The current Kentucky credit is not beneficial to any of those.

Sources: The CPA Journal, a Publication of the NY State Society of CPAs. Anthony Billings, PhD; Milken Institute; The Information, Technology and Innovation Foundation website at www.ITIF.org; 2010 Journal of Accountancy.

Other states:
Other states that have an R&D tax credit usually mirror or are very similar to the federal R&D tax credit. As of 2006 there were 38 states that had R&D credits linked with the federal R&D

tax credit, allowing firms to take a 20 percent credit on increased R&D funding. Since then, the count of states with R&D credits has varied between 35 and 40 and the exact number of states is unknown. However, Indiana, Ohio, and Illinois have R&D credits modeled after the federal. There does not appear to be a similar credit available in Tennessee.

Groups positively and negatively impacted:
It would be beneficial for Kentucky to get a reputation as a state that values and encourages R&D so that university graduates will be motivated to stay here and commercialize their research concepts. It is also beneficial to develop industry clusters by having existing industries (e.g. automotive) developing new technologies that will draw new companies in that industry as well as suppliers. The only known negative impact would be the cost to the General Fund.

Revenue Score: This proposal would be a new tax credit and would be negative to the General Fund. A precise score would depend upon the percentage of the federal credit allowed. A cap on the annual award would mitigate the fiscal impact. Also, if the transferability of the credit was eliminated, the fiscal impact would be mitigated. Establishing a baseline of current R&D activity would be an administrative burden, but not insurmountable.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	**Competitiveness**	**Elasticity**	**Adequacy**	**Simplicity & Compliance**
-	+	-	-	-